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SIPDIS

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TAGS: ECON EFIN ELAB PGOV IT KPRP ITALIAN POLITICS
SUBJECT: Italy's 2005 budget - Smoke and Mirrors

Ref: 04 ROME 4922

SUMMARY

¶1. For the last several years, Italy has relied on extraordinary one-off revenue measures and spending deferrals to avoid bumping up against the euro zone budget deficit/GDP ceiling of three percent. Finance Minister Siniscalco, a technocrat, has sworn off tax amnesties and pursued the most challenging fiscal reforms in the last decade, while also implementing Prime Minister Berlusconi's long-promised tax cut. However, domestic and international budget experts agree that the 2005 mix of spending and tax cuts, coupled with revenue enhancements, will not keep Italy's deficit under the EU ceiling, especially with prognostications now that GDP growth rate will grow at best 1.4 percent, or even less. The GOI will again need to turn to extraordinary budgetary measures to accommodate another swollen budget deficit, most likely after spring elections. End summary.

RECENT BUDGET TRENDS

¶2. For years, Italy's government spending has been high, even by the standards of free-spending EU member states. The result has been large public sector deficits financed by debt. In the early 1990s, however, Italy started to address its macroeconomic problems to qualify for first-round EMU membership. Nonetheless, even at the end of the virtuous path of the nineties, the public sector deficit (as a percentage of GDP) was still dangerously close to the three-percent EU Stability and Growth Pact ceiling. In July 2004, to avoid a EU Commission Early Warning, Italy implemented a 7.5 billion euro deficit reduction package to bring the 2004 deficit in line with the three-percent ceiling. On December 29, 2004, Parliament approved the 2005 budget, totaling euro 645.4 billion (or 45.8 percent of GDP, down from 47.8 percent in 2004). On the surface, the 2005 budget incorporates one of the most aggressive deficit reduction packages in the last decade and seeks both 24 billion euro (or 1.7 percent of GDP) in spending cuts and revenue increases to shrink the budget deficit/GDP ratio to 2.7 percent.

¶3. The level of public debt, the highest as a share of GDP within EMU countries and the second largest of industrialized countries, has started to decline, but still remains over 100 percent of GDP (105.8 percent of GDP at end-2004, down slightly from 106.2 percent at end-2003). Budget drafters think this ratio will not fall below 100 percent before end-2007.

BUDGET/GROWTH ASSUMPTIONS TOO OPTIMISTIC

¶4. The IMF estimates 2005 GDP growth at 1.7 percent, while the GOI estimates 2.1 percent. The Fund warns its projected lower growth, if not offset by further deficit reduction measures in 2005, could lead Italy to overshoot the GOI 2.7 percent budget deficit/GDP target and perhaps even the euro zone three-percent budget deficit/GDP ceiling. The European Commission also questions Italy's budget assumptions and predicts a deficit exceeding the three-percent ceiling in 2005 and 2006. The Commission also believes that 2005 tax cuts are not offset by enough structural spending cuts. Finance Minister Siniscalco, however, has underscored with the EU the GOI commitment to keep the budget deficit/GDP ratio below three percent.

¶5. If economic performance continues as lackluster in 2005 as it was in 2004, even the IMF growth projections

will be hard to hit. Preliminary data indicate a 0.3 percent decline in GDP in fourth quarter 2004. This is the first negative quarter-to-quarter result since second

quarter 2003, and the worst quarter-to-quarter contraction since 1998. This fourth quarter performance reflects weak Italian exports and a struggling industrial sector, especially in the textile, leather, footwear, and car sectors. Industrial production is technically in recession for the last two quarters, and it indicates a weak economy with no prospect for strong short-term recovery. The original GOI assumption of 2.1 percent growth in 2005 now appears too optimistic, as does the IMF estimate of 1.7 percent. However, even the more conservative 1.4 percent projected by The Economist appears unrealistic, given negative fourth quarter 2004 performance. This situation should force the GOI to rethink its budget strategy for 2005 and consider the possibility of GDP growth in 2005 slightly higher than the modest 1.1 percent return in 2004.

EFFECTS OF TAX CUTS AND TAX INCREASES

THE FACTS

¶6. The 2005 budget includes a 4.2 billion euro tax cut to increase disposable income and stimulate domestic demand. The tax cuts provide for three brackets (23, 33, and 39 percent) instead of the previous five (with the highest personal income tax level at 45 percent). Cuts are to be funded in several ways. First, for 2005 only, a four-percent "solidarity contribution," or tax surcharge, will be levied on incomes above 100,000 euro. In addition, there are also increases in indirect taxes and a utility rate increase. Further, the GOI will increase stamp taxes on some transactions, including, banking, boat and real estate purchases. Higher stamp taxes will increase taxes up to 30 percent on real estate and boat sales, fishing, and trademarks. According to a leading consumer association, these tax increases will result in an additional tax burden on households of some 50 to 60 euro a year.

ANOTHER VIEW

¶7. Italian private think tank CER estimated that 2005 tax cuts would have a 0.2 percent positive impact on GDP growth, and a 0.5 percent increase on consumption - although these effects would be mostly offset by inflation. Further, tax cuts will disproportionately benefit higher-income households, as tax cuts did in ¶2003.

¶8. In addition, increasing other taxes to off set income tax decreases does not come without a secondary cost. This creates uncertainty among consumers/tax payers, which could cause them to be more cautious about future spending, thus dampening the expected stimulus of the tax cut. In the case of real estate, the tax increase will have a further negative impact on consumer confidence.

FOREIGN ASSISTANCE

¶9. Severe budget difficulties forced the GOI to reduce its foreign assistance budget for 2005. As a percentage of GDP, Italy's 2005 aid budget equals 0.08 percent, down from the 0.11 percent in 2004. While GOI-pledged funds for Tsunami relief (euro 70 million) are just a different allocation within the 2005 appropriation, the euro 31 million debt relief to Indonesia and euro 7.2 million debt relief to Sri Lanka, are not reflected in these figures.

¶10. Comment: Italy's foreign assistance has not always been this low. In the early nineties, Italy's aid budget was 0.42 percent of GDP; but in 1992, to get finances in order for Economic and Monetary Union (EMU) membership, then-PM Amato more than halved Italy's foreign assistance

to 0.2 percent. Outlays have hovered close to the 1992 levels since then, partially due to the overall budget strictures of EMU membership. Now, Italy limits its assistance to a few key regions. For this reason, Italy's GOI Monterey Summit commitments in 2000 to increase its Foreign Assistance/GDP ratio to 0.7 percent should be seen as a longer-term goal. End comment

DEFENSE

¶11. (Note: The "defense function" includes the budgets of the Army, Navy, and Air Force, but excludes domestic security and other non-essential MOD budget functions. "Defense function" is the largest part of MOD funding. Peacekeeping operations are a separate budget item outside of "defense function." End Note.)

¶12. FY 2005 MOD funding totals Euro 19.0 billion, down 4.0 percent, or 790 million Euro, from FY 2004 funding (19.8 billion Euro). As a percentage of GDP, 2005 MOD funding amounts to 1.35 percent of GDP, compared to 1.47 percent in 2004. (In real terms, assuming a 2.0 percent inflation rate in 2005, the 2005 MOD appropriation is a six-percent decrease from 2004.) The 4.0 percent decrease in total MOD funding includes a 3.7 percent decrease in "defense function." In terms of GDP, defense function equals 1.0 percent of GDP in 2005, compared to 1.1 percent of GDP in 2004. This ratio is lower than that for the UK, France, and Germany. (Note: the GOI had earlier committed to increase the defense function funding/GDP ratio to 1.5 percent by end-2006. Later, however, due to continuing budgetary problems, the target became, more realistically, a medium-long term one. End note.)

¶13. Comment: Continuing budget constraints might have a negative impact on funds for armed forces modernization projects and multi-year commitments. One result is that Italy would be looking for smaller/less costly projects. For its part, the military will sell off Euro 1.2-1.3 billion in property this year in an effort to maintain capabilities. Funds deriving from the sale of military real estate will be earmarked for future military appropriations. End Comment.

PEACEKEEPING

¶14. As mentioned above, peacekeeping funding (for Italy's military missions in Afghanistan, Ethiopia and Eritrea, Sudan, the Balkans, Hebron, and Iraq) is separate from both MOD funding and defense function funding. If we were to add total 2005 MOD budget funding (Euro 19.0 billion) to peacekeeping funding (Euro 1.26 billion, assuming the same level as that for 2004, total defense spending for 2005 would then be USD 20.3 billion, or 1.44 percent of GDP.

¶15. Note: The Treasury budget department (Italy's OMB-equivalent) has confirmed that the 2005 budget includes a euro 1.26 billion appropriation for Italian peacekeeping missions, the same level set in the 2004 budget. However, the Government and Parliament must together agree on how this money will be allocated among the various peacekeeping missions. End Note.

THE TWO-PERCENT GOVERNMENT-SPENDING CAP

¶16. One of the pillars of the 2005 budget strategy is a two-percent government-spending cap to trim 1.93 billion euro of the total 9.5 billion euro in spending cuts included in the 2005 budget. According to a "confidential" Central Bank document, the cap will not be entirely effective; and, for this reason, public sector spending (net of interest payments) is expected to increase by 2.6 percent in 2005. The two-percent cap

will not apply across the board, but just on current spending.

PRIVATIZATION

¶17. The 2005 budget does not provide details on the GOI plan to raise euro 100 billion over the next four years through privatizations of state-owned firms and, in the process, to reduce the debt/GDP ratio from 105.8 percent in 2004 to a target 98.8 percent in 2008. However, as market conditions improve, we expect the GOI to sell off assets again. This year, privatizations could involve ANAS, the State road agency and GOI real estate holding company. The GOI may also sell some of the defense holding companies, Finmeccanica and Terna. Another possibility would be to spin off part of Wind, the integrated communications company (fixed, mobile, internet), owned by ENEL, and thus indirectly by the GOI. Finally, the GOI could privatize RAI, the wholly owned GOI TV and radio firm, before yearend.

COMMENT

¶18. The EU, OECD, IMF, and Bank of Italy have all expressed concern that the budget deficit will exceed three percent of GDP in 2005, and that supplemental measures will be needed. It is difficult to speculate what those measures might be - one-time measures, spending freezes, sale of real estate, etc. The IMF has suggested covering the budget shortfall, euro 6 billion by their estimates, by having consumers pay for some usually free medicines and public services and by implementing a public-sector wage cap -- both tough sells in an electoral campaign season.

¶19. Looking ahead to 2006, despite EU and IMF remarks on the impact of tax cuts on the three percent deficit/GDP ceiling in 2005, the GOI is still planning a twelve billion euro tax cut for 2006, reducing tax brackets from three to two, eliminating the four-percent tax surcharge for income exceeding 100 million euro. While promising a 2006 tax cut will be an important plank in the electoral campaign for spring 2005 regional elections and for spring 2006 national elections, the GOI must still come up with politically-expedient spending cuts to at least partially finance 2006 tax cuts. End comment.

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